RECOVERY ACT

The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively

February 3, 2012

Reference Number: 2012-41-013

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:
2(f) = Risk Circumvention of Agency Regulation or Statute

Phone Number | 202-622-6500
E-mail Address | TIGTACommunications@tigta.treas.gov
Website | http://www.tigta.gov

THE INTERNAL REVENUE SERVICE DISALLOWED ERRONEOUS FIRST-TIME HOMEBUYER CREDITS TOTALING $1.6 BILLION; HOWEVER, ITS EXAMINATION RESOURCES COULD HAVE BEEN USED MORE EFFECTIVELY

Highlights

Final Report issued on February 3, 2011

Highlights of Reference Number: 2012-41-013 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Qualifying taxpayers who purchased a home in Calendar Year 2008, 2009, or 2010 were able to take advantage of the First-Time Homebuyer Credit (Homebuyer Credit), a refundable credit worth up to $8,000. Through July 30, 2011, the IRS reported that it processed more than 4.3 million claims for the Homebuyer Credit totaling almost $30.4 billion. During that same time, the IRS completed 495,592 Homebuyer Credit examinations, with 52,170 still to be closed. The purpose of these examinations is to ensure that only qualified taxpayers receive the Homebuyer Credit. Examining Homebuyer Credit claims that pose the greatest compliance risk is an effective use of limited IRS resources and avoids burdening compliant taxpayers with an examination.

WHY TIGTA DID THE AUDIT

This audit was initiated because a prior TIGTA audit estimated that IRS control weaknesses allowed taxpayers who most likely did not qualify for the Homebuyer Credit to receive potentially erroneous refunds of more than $513 million. The overall objective of this review was to determine whether the IRS was adequately addressing questionable claims for the Homebuyer Credit.

WHAT TIGTA FOUND

The IRS developed a comprehensive strategy to address erroneous claims for the Homebuyer Credit. While it properly evaluated the questionable claims that were selected for examination, a large number of high-risk claims were not examined, and many of the examinations conducted were unproductive. More specifically, some of the high-risk claims were never run through the automated filters designed to select claims for examination. In addition, the IRS's methods for determining the highest risk claims were flawed. TIGTA also found that certain examination tolerances resulted in many high-risk claims going unexamined. Finally, the IRS exceeded its legal authority in denying Homebuyer Credits to some taxpayers under 18 years of age.

WHAT TIGTA RECOMMENDED

During the course of the audit, TIGTA made recommendations that resulted in immediate IRS corrective actions. IRS management modified their methods of determining high-risk claims and shifted examination resources to more productive cases. They also agreed to use a method other than post-processing math error authority to address claims filed by under-age taxpayers.

In addition, TIGTA recommended that the IRS 1) use updated examination results to make adjustments throughout the year, which will optimize the overall examination results, and 2) ensure that all claims for the Homebuyer Credit are run against IRS automated examination filters and that the highest risk cases are selected for post-refund examinations.

The IRS agreed with our recommendations. In its response to the first recommendation, the IRS stated it routinely uses prior examination results to adjust its workloads. Nonetheless, TIGTA found that the IRS did not do this consistently in the case of Homebuyer Credit examinations.

The IRS disagreed with one of the outcome measures discussed in this report. However, TIGTA believes that the IRS did not consider pertinent data regarding its high percentage of no-change cases for pre-refund Homebuyer Credit examinations.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

February 3, 2012

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively (Audit # 201040151)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) Compliance function adequately addressed questionable claims for the First-Time Homebuyer Credit. This audit was included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Erroneous and Improper Payments and Credits.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

Management's complete response to the draft report is included in Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).

Table of Contents

Abbreviations

CY	Calendar Year
HERA	Housing and Economic Recovery Act of 2008
IRS	Internal Revenue Service
PY	Processing Year
TY	Tax Year
WHBAA	Worker, Homeownership, and Business Assistance Act of 2009

Background

The Housing and Economic Recovery Act of 2008 (HERA)[1] allowed first-time homebuyers[2] who purchased a principal residence after April 8, 2008, and before July 1, 2009, to claim a refundable credit equal to 10 percent of the purchase price of the home, limited to $7,500. The First-Time Homebuyer Credit (Homebuyer Credit), as expressed in this Act, served as an interest-free loan to be paid back over a 15-year period beginning two years after the Homebuyer Credit was claimed.

Section 1006 of the American Recovery and Reinvestment Act of 2009 (Recovery Act)[3] extended the Homebuyer Credit to include purchases made on or after January 1, 2009, and before December 1, 2009, increased the maximum Homebuyer Credit to $8,000, and eliminated the repayment requirement as long as the taxpayers retain the home as their principal residence for at least 36 months. Taxpayers had several filing options to claim the Homebuyer Credit, including claiming it on their current income tax return or, in some cases, amending a prior year return to claim the Credit.[4] Taxpayers who qualified for the revised Homebuyer Credit could claim the $8,000 Credit on either their Tax Year (TY) 2008 or 2009 individual income tax returns. Taxpayers may have been confused regarding which version of the Homebuyer Credit they qualified for, and unscrupulous individuals made fraudulent claims for the refundable Credit.

Taxpayers may have been confused regarding which version of the Homebuyer Credit they qualified for, and unscrupulous individuals made fraudulent claims for the refundable Credit.

The Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA),[5] signed into law on November 6, 2009, extended and expanded the Homebuyer Credit allowed by the previous

[1] Pub. L. No. 110-289.
[2] See Appendix V for a glossary of terms.
[3] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[4] For qualifying homes purchased in Calendar Year (CY) 2008, the Homebuyer Credit could be claimed by filing an original Tax Year (TY) 2008 Form 1040, *U.S. Individual Income Tax Return*, or by amending a TY 2008 return using Form 1040X, *Amended U.S. Individual Income Tax Return*. For qualifying homes purchased in CYs 2009 or 2010, the Homebuyer Credit could be claimed on an original filed TY 2008 (homes purchased in CY 2009 before a TY 2008 return was filed could be treated as purchased in CY 2008 and claimed on an original TY 2008 return), 2009, or 2010 return, or taxpayers could elect to amend their prior year tax return using Form 1040X. Amending the prior year tax return allows taxpayers to claim the Homebuyer Credit for a home purchased in CYs 2009 or 2010 without waiting to claim it on their TY 2009 or 2010 return.
[5] Pub. L. No. 111-92, 123 Stat. 2984 (2009).

Acts.[6] However, the WHBAA also addressed fraudulent claims for the Homebuyer Credit by adding documentation requirements for claiming the Credit and providing the Internal Revenue Service (IRS) with math error authority to address certain erroneous claims.

Congress estimated that $13.6 billion would be paid to taxpayers for the Homebuyer Credit in the HERA. The Joint Committee on Taxation estimated that more than $4.3 billion in additional credits would be paid to first-time homebuyers in Fiscal Years 2009 and 2010 as a result of the Recovery Act. The Committee also estimated that more than $12.7 billion would be paid to homebuyers in Fiscal Years 2010 and 2011 as a result of the extension and modification of the WHBAA provisions.

The President of the United States stated that every taxpayer dollar spent on the economic recovery must be subject to unprecedented levels of transparency and accountability. The President called on Federal agencies to ensure that recovery funds were used for authorized purposes and every step taken to prevent instances of fraud, waste, error, and abuse.

This review was performed at the IRS Ogden, Utah, Campus during the period August 2010 through September 2011 and included a review of individual income tax returns filed nationwide. Site visits were made to the Examination functions located at the IRS Campuses in Kansas City, Missouri; Austin, Texas; and Ogden, Utah. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[6] Under the new law, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010, and close on the home by June 30, 2010. The law maintained that the taxpayer would not be required to repay the Homebuyer Credit and kept the maximum amount at $8,000. For qualifying purchases in CY 2010, taxpayers have the option of claiming the Credit on either their TY 2009 or 2010 tax returns.

Results of Review

A Comprehensive Strategy Was Developed to Address Erroneous Claims for the Homebuyer Credit

The IRS had to address the various nuances associated with each version of legislation and has expended a great amount of work and effort to process Homebuyer Credits, identify questionable claims, and stop or recover refunds resulting from erroneous claims. As part of the overall implementation of the Homebuyer Credit, the IRS developed controls and took a number of steps to prevent inappropriate Credits from being issued. Primary among these controls was the implementation of examination filters to identify questionable claims for the Homebuyer Credit before they were processed. Questionable claims, filed on both original and amended returns, were identified by the filters and then further evaluated and scrutinized through the examination process.

Through July 30, 2011, the IRS reported that it processed more than 4.3 million taxpayer claims for the Homebuyer Credit totaling almost $30.4 billion.

The IRS implemented its examination filters on May 17, 2009, to identify questionable Homebuyer Credit claims based on the taxpayer's current and prior tax return information. More than 1.1 million returns claiming the Homebuyer Credit were processed prior to the implementation of the filters. The IRS subsequently ran most of these early filed claims against its filters in October 2009. However, as we discuss later in this report, some early filed returns were not run against the IRS's filters.

After passage of the WHBBA in November 2009, the IRS began requiring documentation of home purchases to support claims for the Homebuyer Credit and used its math error authority to immediately disallow certain claims for the Credit.

Through July 30, 2011, the IRS reported that it processed more than 4.3 million taxpayer claims for the Homebuyer Credit totaling almost $30.4 billion. During that same time, as shown in Figure 1, the IRS completed 495,592 examinations (52,170 open examinations remain to be completed) on original Forms 1040, *U.S. Individual Income Tax Return*, and Forms 1040X, *Amended U.S. Individual Income Tax Return*. Almost 88 percent (435,063) of the closed examinations were performed prior to the release of the refund (pre-refund). This avoids improper refunds and the associated difficulty in trying to collect the amount improperly refunded. The completed examinations have resulted in more than $1.57 billion being stopped before a refund was issued or assessed to the taxpayer's account subsequent to the refund being issued (post-refund).

Figure 1: Homebuyer Credit Examinations

Type of Examination	Number of Examinations Initiated	Number of xaminations Closed	Percentage of Homebuyer Credits Disallowed	mounts Disallowed
Pre-refund	196,615	189,552	43%	$583,403,152
Post-refund	96,706	60,529	31%	$122,152,734
1040X	254,441	245,511	53%	$873,883,387
Total	**547,762**	**495,592**		**$1,579,439,273**

Source: IRS Examination function (as of July 22, 2011).

Because audit resources are limited, this large number of Homebuyer Credit examinations resulted in a decrease in the number of regular discretionary audits performed.

Questionable claims for the Homebuyer Credit accepted as filed as well as those selected for examination were properly evaluated

Claims for Homebuyer Credits which triggered examination filters were automatically sent to the Examination function for classification. Examination classifiers could either accept the claim as filed or select them for examination. We reviewed samples of claims for the Homebuyer Credit which were accepted as filed prior to examination and claims that were examined. In general, we found that claims for the Homebuyer Credit that were accepted as filed prior to examination had been properly evaluated by IRS tax classifiers.

We also found that claims accepted for examination were properly evaluated. An IRS tax examiner begins an examination of a questionable claim for the Homebuyer Credit by determining which filter caused the claim to be selected for examination. The examiner then corresponds with the taxpayer to request documentation to resolve the issue and validate the claim. Once the supporting documentation is received, the examiner is responsible for determining whether to allow or disallow the Credit based on the documentation provided by the taxpayer. The examiner is required to notate in the case file the reasons why the Credit was allowed or disallowed. For example, if a claim for the Homebuyer Credit is being examined due to a triggered filter indicating the taxpayer owned a home within the last three years, the tax examiner would contact the taxpayer, request an explanation, and ask for support to prove purchase of and residency in the new home. The taxpayer would then need to provide documentation that includes an adequate explanation as well as the supporting documentation. The tax examiner is required to note the information provided in the taxpayer's case file.

As of September 2010, IRS tax examiners had examined and closed 297,939 cases related to the Homebuyer Credit. We found that 154,640 (52 percent) claims had been verified as appropriate and were refunded to the taxpayers. We reviewed a statistically valid sample of 384 of these cases (242 amended and 142 original returns) and analyzed tax examiners' case files maintained on each case.

We reviewed examiner notes to determine whether the examiner requested and the taxpayer provided the documentation needed to substantiate eligibility for the Homebuyer Credit. We found that the tax examiners consistently followed IRS requirements and effectively determined whether the taxpayers were entitled to the Homebuyer Credit. Tax examiners obtained supporting documents and properly substantiated 374 (97 percent) of the 384 cases. Only 10 cases (2.6 percent) remained questionable because the supporting documents and explanations provided by the taxpayers did not appear to provide adequate support to address the issue which triggered the examination filter.

Further, we found that during the examination process, the IRS properly released those portions of the refund not associated with the questionable Homebuyer Credit claims. In many instances, taxpayers claiming the Homebuyer Credit were due an additional refund from the IRS because of withholdings or other refundable credits. Instead of holding the entire refund until the examination closed, the IRS protected taxpayers' rights and correctly froze only the portion associated with the Homebuyer Credit.

A Large Number of High-Risk Homebuyer Credit Claims Were Not Examined

Notwithstanding the IRS's efforts, we believe that its examination resources could have been used more effectively. As previously discussed, the IRS did not implement its examination filters until after more than 1.1 million returns claiming the Homebuyer Credit had been processed. To ensure that all questionable claims were identified, the IRS subsequently ran most of these early filed claims against its filters. The IRS identified 250,159 questionable claims filed on TY 2008 returns during this process, but determined it had resources to audit only the 69,953 that it considered to be the most egregious.

A Congressional Hearing before the House Ways and Means Subcommittee on Oversight held during October 2009 addressed the importance of identifying erroneous claims that were processed prior to the implementation of IRS filters. During that hearing, the IRS Deputy Commissioner for Services and Enforcement stated, "The fact that it (a questionable claim) was not stopped on the front-end does not mean we are not addressing each and every one of those."

The IRS used limited examination resources auditing Homebuyer Credits for which liabilities for repayment already existed rather than higher risk cases

Given the importance placed on ensuring that all questionable claims be addressed and the fact that the IRS's examination resources are limited, we analyzed the 69,953 claims selected for post-refund examination as well as those not selected to determine if the best cases had been selected. We determined that many of the excluded cases were higher risk cases than those planned for examination. Our determination was based primarily on the assumption that, all other things being equal, Homebuyer Credits for homes purchased in Calendar Year (CY) 2009 present a higher risk than those for homes purchased in CY 2008. We based this assumption on the following facts:

- Homebuyer Credits for homes purchased in CY 2009 are for amounts up to $8,000, while those for homes purchased in CY 2008 are for amounts up to $7,500.
- Taxpayers receiving Homebuyer Credits for homes purchased in CY 2008 are already under a legal requirement to pay back the amount received over a 15-year period. Therefore, the urgency to initiate an examination on those cases and to assess a deficiency is reduced. Conversely, taxpayers receiving Homebuyer Credits for homes purchased in CY 2009 are under no obligation to repay unless an examination assessment is made. Therefore, the Government's interests were already protected for Credits based on CY 2008 purchases but were not protected for Credits based on CY 2009 purchases. Figure 2 shows the basic information for homes purchased in CYs 2008 and 2009.

Figure 2: Basic Information for Homes Purchased in Calendar Years 2008 and 2009

	Homes Purchased April 9 – December 31, 2008	**Homes Purchased January 1 – November 6, 2009**
Homebuyer Credit Amount	Lesser of: • **$7,500** or • 10% of purchase price	Lesser of: • **$8,000** or • 10% of purchase price
Payback Requirements	Credit is an interest-free loan that must be paid back over 15 years beginning with the TY 2010 individual income tax return.	No payback. Taxpayer does not have to repay the Credit as long as the home remains the main residence for 36 months after the purchase date.

Source: IRS.gov.

We found that only 2,853 of the 69,953 claims identified for examination were for homes purchased in CY 2009, despite the fact that 43,786 claims for CY 2009 purchases triggered at least one of the IRS's examination filters, and 4,550 of these claims were identified by a filter indicating a high probability of fraud.

In December 2010, we immediately notified the IRS and recommended that it reevaluate the priority given to the cases planned for examination and place a greater emphasis on claims for homes purchased in CY 2009 but claimed on TY 2008 returns (as allowed for in the law). We recommended that claims based on CY 2009 home purchases be worked before and receive a greater priority than claims based on CY 2008 home purchases when "questionable claim indicators" were similar.

The examination disallowance rate that should have been used for comparison was the rate on early filed Homebuyer Credits for homes purchased in CY 2009

IRS management disagreed with our recommendations to give CY 2009 purchases greater priority. The basis for their disagreement was their opinion that the examination disallowance rate for Homebuyer Credits for homes purchased in CY 2009 was much lower than the disallowance rate for Credits for homes purchased in CY 2008. IRS management was mistaken.

We determined that the analysis performed by the IRS in determining the low disallowance rate for CY 2009 purchases did not consider the effect of new requirements enacted into law during CY 2010 that affected subsequent taxpayer compliance. The Homebuyer Credit claims at issue were all filed early in Processing Year (PY) 2009 (prior to the implementation of IRS filters) and were all claimed on TY 2008 Forms 1040. We analyzed the actual examination disallowance rates for claims filed early in the year and compared the rates for claims based on CY 2009 purchases and CY 2008 purchases. We included only claims filed on TY 2008 returns. We found that through August 13, 2009, the cumulative disallowance rate for claims based on CY 2009 purchases was actually slightly higher (75.9 percent) than for claims based on CY 2008 purchases (75.6 percent).

The disallowance rate on claims for CY 2009 purchases the IRS calculated for its comparison of CYs 2008 and 2009 purchases was based on CY 2009 purchases filed throughout all of PYs 2009 and 2010. The disallowance rate on these claims was very high throughout most of PY 2009, but it declined significantly in PY 2010 after new legislation was enacted to require taxpayers to provide documentation to support claims for the Homebuyer Credit and after considerable media coverage regarding the IRS's efforts to address erroneous claims for the Credit. Therefore, the PY 2010 disallowance rate should not have been factored into the analysis to determine the priority given to questionable Homebuyer Claims based on CYs 2008 and 2009 purchases filed early in PY 2009.

The IRS subsequently agreed to change the examination priority on claims

After discussing with the IRS our concerns about its analysis, we again recommended that, given similar questionable claim criteria, higher priority should be given to claims for homes purchased in CY 2009. We recommended that the IRS reallocate its resources to ensure that all claims identified by one of the fraud filters be examined first, regardless of whether the claim was based on a CY 2008 purchase or a CY 2009 purchase, and then all the remaining claims based on CY 2009 purchases be examined.

The IRS agreed with our recommendations and took corrective action to examine all claims with indications of fraud and as many questionable claims based on CY 2009 purchases as possible.

IRS management indicated that, based on our recommendation, they have worked or plan to work an additional 16,730 of these post-refund cases. We estimate that these actions will result in the IRS disallowing Homebuyer Credits totaling approximately $92 million.

<u>Office of Audit Comment</u>: IRS management disagreed with the $92 million measure. Management stated that the change to the case selection methodology resulted in the audit of an additional 16,730 post-refund Homebuyer Credit claims. However, management stated there was an offset because these examinations displaced, or caused the non-selection of, other claims or returns that would have been examined. Management's view is that the outcome measure does not consider the additional tax assessments, or claim disallowances that would have been derived from those displaced returns.

Based on this reasoning, it does not appear the IRS considered that the displaced cases were the pre-refund Homebuyer Credit cases that it agreed to discontinue examining. We estimated, and the IRS agreed, that approximately 15,524 pre-refund examinations would have been conducted on Homebuyer Credit cases had it not discontinued selecting these cases for examination. Pre-refund Homebuyer Credit examinations had a no-change rate of approximately 83 percent, meaning the Government would have received nothing from examining 83 percent of the cases (see Figure 3 on page 11). Therefore, approximately 13,000 of these examinations would have resulted in no change to the tax owed. We worked with the IRS's Examination function to obtain data regarding potential examination results on the displaced cases, but it could not provide the data or a reliable estimate.

***<u>**2(f)**
**************2(f)*****************</u>***

***************************************2(f)*****************************
***************************************2(f)*****************************.
***************************************2(f)*******************************
2(f)**************************
2(f)***************************
2(f)**************************
***************************************2(f)******************************.

***************************************2(f)*******************************
2(f)**************************
***************************************2(f)*******************************
2(f)***************************
2(f)**************************,
2(f)***************************
2(f)*************************.

2(f)***************************
2(f)*****************************
2(f)*****************************
2(f)****************************
2(f)***************************
2(f)****************************
*************2(f)*******************.

2(f)***************************
2(f)*****************************
2(f)*****************************
2(f)****************************
2(f)****************************
2(f)****************************
**********************2(f)************.

*********************************.************2(f)****************************
2(f)*************************
2(f)*****************************
2(f)**************************
2(f)******************************
2(f)******************************.[7]

2(f)*****************************
2(f)***************************
2(f)****************************
***********************2(f)******************.

2(f)******.**********************
2(f)****************************
2(f)**************************
2(f)************************
2(f)*************************
2(f)*************************
2(f)**************************
2(f)***************************
*************2(f)************.

[7] ***2(f)******************************
2(f)*****************************
******************2(f)****************.

*********************************2(f)************************************
*********************************2(f)************************************
*********************************2(f)*************************************
****************************2(f)*********************.

*******************************.***2(f)************************************
**********************************2(f)**********************************
**********************************2(f)************************************
***********************************2(f)************************************
***********************************2(f)*********************************
***********************************2(f)************************************
******************************2(f)****************.

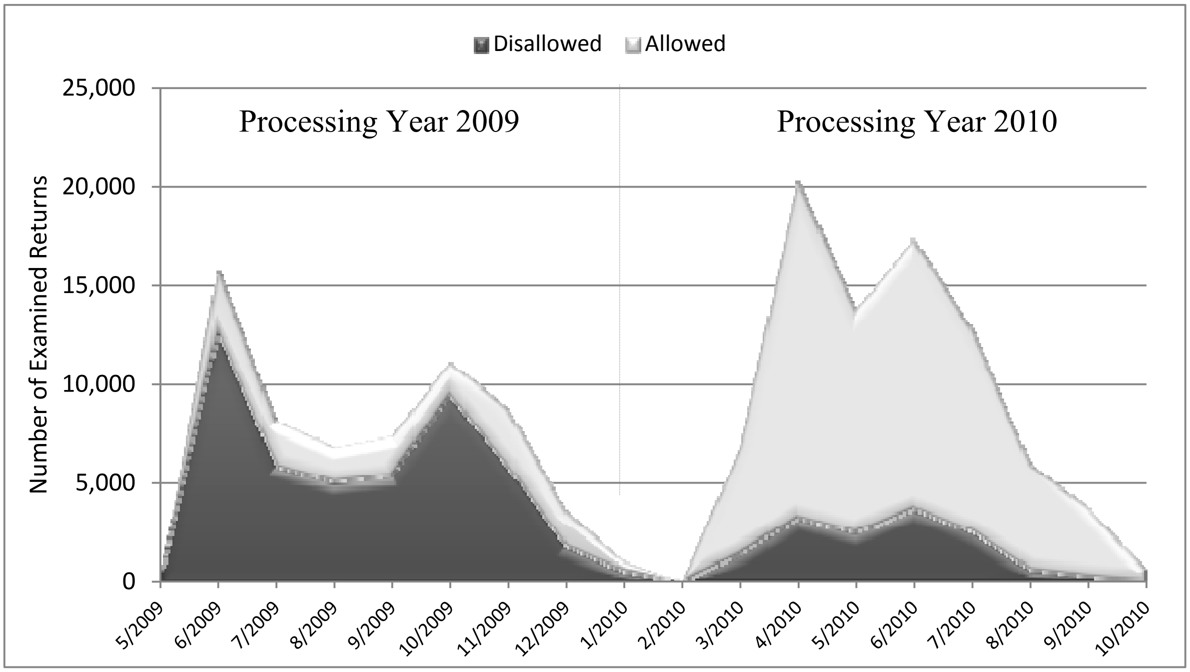
**********************************2(f)************************************
***********************************2(f)*********************************
************************************2(f)************************************
**************************2(f)****************************.

Audits of Homebuyer Credit Claims Submitted After Enactment of Additional Legal Requirements Were Not As Productive

The IRS successfully examined and disallowed a high percentage of erroneous claims for the Homebuyer Credit claimed and processed during PY 2009. These were claims identified by the examination filters and were examined prior to the issuance of refunds. However, during PY 2010, the IRS's disallowance rate on pre-refund Homebuyer Credit cases declined substantially. Despite this lack of success, the IRS continued to apply examination resources to more of these claims.

For cases processed during PY 2009, the IRS disallowed approximately 75 percent (49,276 out of 65,848) of the Homebuyer Credits examined before refunds were released. However, the overall disallowance rate for PY 2010 claims was only 17.5 percent (14,417 out of 82,416). Further, for most of the year, the disallowance rate remained less than 13 percent. Figure 3 shows a comparison between the examination results of claims processed in PY 2009 versus claims processed in PY 2010.

Figure 3: Examination Results for First-Time Homebuyer Credits Filed on Original Returns



Source: Our analysis of Homebuyer Credit examinations.

As discussed earlier, the passage of the WHBAA in November of CY 2009 provided new controls to help address fraudulent claims for the Homebuyer Credit, including documentation requirements and math error authority. However, IRS management did not assess the effect of these controls on the compliance rate for the Homebuyer Credit or on the productivity of the examination program. This issue increases in significance when considering that a large number of high-risk cases were not examined because of limited IRS resources. These cases were processed early in PY 2009 before implementation of the examination filters and during a period when the estimated disallowance rate for the Homebuyer Credit was never lower than 73 percent.

In March 2011, we discussed the low disallowance rates with the IRS and emphasized the ineffectiveness of these examinations. As a result, the IRS immediately discontinued its pre-refund examinations of these claims, with the exception of those made by ***2(f)*** and those for homes not purchased within the time period specified in the law. Based on subsequent filing data, we estimate that as a result of taking this action, the IRS avoided burdening at least 12,808 taxpayers with unnecessary audits.

Recommendation

Recommendation 1: Given limited examination resources, the Director, Compliance, Wage and Investment Division, should use updated examination results to make adjustments throughout the year, which will optimize the overall effectiveness of examinations.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS routinely uses prior examination results, when available, to develop its selected workloads and to make adjustments throughout the year. The IRS also considers examination results and trends when developing its annual program plans.
>
> ***Office of Audit Comment:*** Although the IRS agreed with our recommendation, its statement that it routinely uses prior examination results to develop selected workloads and to make adjustments throughout the year is not consistent with what we found in the case of Homebuyer Credit examinations. We believe the IRS should determine why the problem occurred in this instance and take action to ensure all categories of cases are evaluated and adjusted appropriately throughout the year. In the case of Homebuyer Credit examinations, early adjustments to examination selection criteria based on ongoing audit results could have resulted in millions of dollars of funds put to better use.

Some Claims for Homebuyer Credits Were Never Run Through Automated Filters

As discussed earlier, to ensure that all questionable claims for the Homebuyer Credit were properly identified, the IRS performed a subsequent computer run designed to filter claims for the Homebuyer Credit processed before its examination filters were originally implemented. To determine whether all Homebuyer Credits had been subjected to these filters, we designed our own computer program to apply the criteria for the IRS's filters (filters noting prior home ownership, ****************2(f)*****************) against these early filed claims and matched the questionable claims we identified against those identified by the IRS. Using just these filters, we found a significant number of questionable claims that the IRS did not identify. After further analysis, we determined that the IRS omitted Homebuyer Credit claims processed the weeks of May 3, 2009, and May 10, 2009, (processing cycles 19 and 20) from its subsequent filter run.

We notified the IRS of our finding. In its response, the IRS stated that a manual filtering process was in place during that specific time period. The IRS gave no indication and we found no evidence that those claims were ever run against the automated filters.

The IRS manual filters identified 6,404 questionable Homebuyer Credit claims and shared many of the same criteria as the automated filters. However, applying just the automated filters previously discussed, we found an additional 4,514 claims totaling more than $33.9 million processed during these two weeks that were not identified by the manual filters. We were unable to apply the criteria for all of the IRS's filters, so it is possible that even more questionable Homebuyer Credit claims processed during this time period were not identified by the IRS for examination consideration.

Recommendation

Recommendation 2: The Director, Compliance, Wage and Investment Division, should ensure that claims for the Homebuyer Credit processed in processing cycles 19 and 20 are run against the IRS's automated examination filters and that the highest risk cases are selected for post-refund examinations.

> **Management's Response:** IRS management agreed with this recommendation and will examine the highest risk cases.

Math Error Authority Was Incorrectly Used Retroactively on Homebuyer Credit Claims for Taxpayers Under 18 Years of Age

In response to a prior Treasury Inspector General for Tax Administration recommendation,[8] the IRS developed an "under-age" filter to identify claims for the Homebuyer Credit made by taxpayers under 18 years of age. The IRS attempted to apply this filter to all Homebuyer Credit claims filed prior to the filter's implementation. However, the IRS omitted Homebuyer Credit claims filed between May 9 and September 15, 2009, (processing cycles 19 through 37) when applying the under-age filter to previously processed claims. This occurred because the IRS overlooked that the under-age filter was not actually implemented until September 15, 2009, long after the other filters were in place. As a result, even though the IRS included the under-age filter along with the other filters when evaluating the claims filed before any filters were implemented, it failed to recognize that there were additional weeks of claims made by under-age taxpayers that had never been addressed.

We notified the IRS that 822 claims made by taxpayers under age 18 and processed before September 15 were not properly identified. We recommended that the IRS ensure all under-age claims processed after cycle 18 and prior to cycle 38 were identified. The IRS agreed to conduct a review of the 822 cases and make

---

[8] Treasury Inspector General for Tax Administration, Ref. No. 2009-41-144, *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit*, page 8 (Sept. 2009).

appropriate adjustments to the accounts of those that fell under 18 years of age. After reviewing the claims referred by the Treasury Inspector General for Tax Administration, the IRS informed us that 342 cases were audited (based on other filters), three were already adjusted, and the remaining 477 claims would be worked under post-processing math error authority.

One provision of the WHBAA prohibited taxpayers under 18 years of age from claiming the Homebuyer Credit. Prior to this Act, although claims for the Credit made by taxpayers under age 18 were highly questionable, these taxpayers were not prohibited by law from receiving the Homebuyer Credit. In addition, the WHBAA provided the IRS with math error authority for certain questionable claims for the Homebuyer Credit, including claims made by taxpayers under the age of 18.

Math error authority enables the IRS to correct or disallow certain items on a tax return based on obvious errors and avoids the need for labor-intensive audits. Because math error assessments do not provide taxpayers the same rights associated with IRS deficiency procedures, Congress has historically limited this authority to specific, narrow circumstances.[9] Usually, math error authority is imposed during the processing of a return. In the cases previously discussed, the IRS was imposing this authority after refunds were issued.

According to the IRS, math error authority is an alternative to issuing a notice of deficiency. It had previously used math error authority only when processing returns. However, it is now the IRS's view that the law does not limit the use of math error authority to the initial processing of returns. As such, if the IRS finds that the taxpayer has a math error on his or her return, it is authorized to make the adjustment, whether or not the taxpayer's refund has been issued. The IRS decided to use this approach on these Homebuyer Credit claims. However, because claims for the Homebuyer Credit made by taxpayers under the age of 18 were not prohibited by law until the passage of the WHBAA, asserting post-processing math error authority on these claims (which were filed and processed before the WHBAA was passed) was inappropriate.

We immediately informed the IRS of our concerns. While the claims made for the Homebuyer Credit by taxpayers under the age of 18 are questionable and warrant scrutiny, we recommended that the IRS use a method other than post-processing math error authority to address the claims filed by these 477 taxpayers.

The IRS agreed with our recommendation and indicated that it is currently reviewing these taxpayers' claims for the Homebuyer Credit and will open examinations where warranted. However, it appears that the IRS improperly asserted post-processing math error authority on some cases before we were able to notify them of our concern.

---

[9] National Taxpayer Advocate 2006 Annual Report to Congress, "*Taxpayers who are summarily assessed additional tax via a "math error" notice may not be afforded the same rights as those who are assessed additional tax through normal IRS deficiency procedures. Math error authority allows the IRS to summarily assess tax before a taxpayer has the opportunity to challenge the assessment in the U.S. Tax Court.*"

On June 14, 2011, the IRS issued a Servicewide Electronic Research Program Alert explaining that some taxpayers had been inappropriately denied the Homebuyer Credit solely because they were under age and that they had been notified of this fact in a letter. The Alert explained that these cases had not been correctly addressed and included instructions to apologize to taxpayers if they were to call with questions regarding the matter. The Alert indicated that these cases had been corrected by issuing the Credit back to the taxpayers' accounts and issuing letters to the taxpayers informing them that the earlier letter denying them of the Credit was in error. The IRS did note in the letter that the Homebuyer Credit had not been disallowed but that their tax return may be subject to further examination.

As a result of the IRS's corrective actions, these 477 taxpayers were provided the specific rights associated with the IRS's deficiency process to which they were entitled. In addition, based on the IRS's overall disallowance rate of 91 percent on audits of Homebuyer Credits made by taxpayers under age 18, we estimate that 43 of the 477 taxpayers would have been denied Homebuyer Credits totaling more than $285,000 to which they were entitled.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS Compliance function was adequately addressing questionable claims for the First-Time Homebuyer[1] Credit (Homebuyer Credit). This audit covers procedures for addressing questionable claims on both original returns and amended returns. To accomplish our objective, we:

I. Evaluated the IRS's overall compliance strategy (or examination plans) for addressing questionable requests for the Homebuyer Credit.

   A. Determined whether the strategy/plan adequately addresses Homebuyer Credits claimed on original and amended returns.

   B. Determined whether the strategy/plan addresses cases flagged by pre-refund filters as well as those processed before those filters were implemented.

   C. Determined whether the plan addresses staffing and resource needs to address the significant number of questionable Homebuyer Credits.

   D. Interviewed Examination function management to determine whether cases triggering individual filters have been analyzed for high/low change rates and whether these rates have been incorporated into the examination processes.

II. Evaluated the processes for identifying, screening, and examining questionable requests for the Homebuyer Credit filed on original tax returns.

   A. Reviewed IRS procedures and controls designed to identify questionable requests for the Homebuyer Credit filed on original tax returns.

      1. Interviewed Examination function management to discuss the programs, procedures, and controls that have been designed to identify questionable requests for the Homebuyer Credit that were not identified by filters.

      2. Determined whether the pre-refund filters developed by the IRS were updated timely as new areas of noncompliance were identified.

      3. Determined whether the IRS took adequate steps to identify potential noncompliance associated with requests for the Homebuyer Credit not identified by its pre-refund filters.

[1] See Appendix V for a glossary of terms.

a. Obtained databases used in a previous Treasury Inspector General for Tax Administration audit[2] that contained categories of questionable cases processed before the implementation of pre-refund filters or not addressed by the IRS's pre-refund filters including:

- 19,351 Homebuyer Credit cases that contained future purchase dates.
- 69,966 Homebuyer Credit cases where the taxpayers had indications of prior home ownership within three years.
- 1,669 Homebuyer Credit cases involving taxpayers under the age of 18.
- 2,751 Homebuyer Credit cases with home purchases prior to the dates allowed for in the law.
- 4,608 Homebuyer Credit cases filed by ******2(f)**********
- 14,186 Homebuyer Credit cases for purchases from related parties.
- 7,948 Homebuyer Credit cases with no valid addresses of the homes purchased.

b. Obtained a database of all examination files related to the Homebuyer Credit. This included files from the Data Center Warehouse and files provided to us by the IRS. We validated the data from each of the files by comparing 50 taxpayer accounts to information found on the IRS Individual Master File.

c. Determined if the cases identified in Step II.A.3.a. were included in the examination files from Step II.A.3.b.

d. Reviewed a statistically valid sample[3] of 355 questionable returns[4] processed in cycles 19 and 20 that were not included in the closed examination files to determine if the IRS properly identified the cases.

B. Reviewed the IRS's processes and procedures for screening questionable requests for the Homebuyer Credit filed on original tax returns (whether worked pre-refund or post-refund).

---

[2] Treasury Inspector General for Tax Administration, Ref. No. 2011-41-035, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (Mar. 2011).
[3] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level.
[4] The questionable returns included claims for *****************2(f)**********************************
2(f)********************, and 3) prior home ownership. This sample was selected from a population of 4,514 records.

1. Determined whether controls are in place to ensure adequate steps are taken when taxpayers do not respond timely.
2. Reviewed a statistically valid sample[5] of 383 cases accepted as filed prior to contacting taxpayers to determine whether potential areas of noncompliance were adequately addressed.
3. Determined whether cases selected for examination are prioritized based on their potential for noncompliance (potential outcomes) and whether the priorities are updated based on actual audit results.
   a. Determined whether post-refund American Recovery and Reinvestment Act of 2009 (Recovery Act)[6] and WHBAA[7] cases are given priority over post-refund HERA[8] cases (which must be repaid by law).
   b. Reviewed a statistically valid sample[9] of 368 cases to determine whether the IRS's tolerance levels were adjusted ******************2(f)*********** *******2(f)*****************.
   c. Reviewed a statistically valid sample[10] of 299 cases to determine whether the IRS's tolerance levels were adjusted *****************2(f)*********** ************2(f)************.
   d. Reviewed a statistically valid sample[11] of 310 cases to determine whether the IRS's tolerance levels were adjusted ****************2(f)*********** **********************2(f)*****************.

[5] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. The sample included 18 claims filed on an original return from a population of 68,083 records.
[6] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[7] Pub. L. No. 111-92, 123 Stat. 2984 (2009).
[8] Pub. L. No. 110-289.
[9] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. These included cases from a population of cases meeting the following criteria: 1) **********************2(f)************************, 2) filed in cycles 19 through 38 in Processing Year 2009, and 3) based on a CY 2009 purchase. This sample was selected from a population of 8,395 records.
[10] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. These included cases from a population of cases meeting the following criteria: 1) ******************2(f)*****************************, 2) filed in cycles 19 through 38 in Processing Year 2009, and 3) based on a CY 2009 purchase. This sample comes from a population of 1,342 records.
[11] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. These included cases from a population of cases meeting the following criteria: 1) ***********************************2(f)***********************************, and 3) filed in cycles 19 through 38 in Processing Year 2009. This sample comes from a population of 1,605 records.

e. Determined whether processes were developed to allow those portions of taxpayers' refunds resulting from withholding or other non-Homebuyer Credit issues to be released to taxpayers whose Homebuyer Credits will not be examined immediately.

B. Reviewed the IRS's processes for examining questionable requests for the Homebuyer Credit filed on original tax returns (whether worked pre-refund or post-refund).

1. Reviewed closed cases for which the Homebuyer Credit was allowed to determine whether potential areas of noncompliance were adequately addressed.

a. Selected a statistically valid sample[12] of 384 closed cases for which the Homebuyer Credit was allowed (surveyed before assignment, surveyed after assignment, and closed – no change).

b. Reviewed the original returns in the sample to determine whether the taxpayers provided adequate documentation to substantiate their eligibility for the Homebuyer Credit.

2. Determined whether cases are being worked in appropriate priority order and whether examination results are being used to update priorities.

III. Evaluated the processes for identifying, screening, and examining questionable requests for the Homebuyer Credit filed on amended tax returns.

A. Reviewed IRS procedures and controls designed to identify questionable claims for the Homebuyer Credit filed on amended tax returns.

1. Determined whether the Category-A filters developed by the IRS were updated timely as new areas of noncompliance were identified.

2. Determined whether the IRS took adequate steps to identify potential noncompliance associated with claims for the Homebuyer Credit not identified by its Category-A filters.

B. Reviewed the IRS's processes and procedures for screening questionable requests for the Homebuyer Credit filed on amended tax returns.

[12] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. The sample included 142 claims filed on an original return from a population of 154,640 records.

1. Reviewed a statistically valid sample[13] of 383 cases accepted as filed to determine whether potential areas of noncompliance were adequately addressed.

2. Determined whether post-refund cases selected for examination are prioritized based on their potential for noncompliance (potential outcomes), and whether the priorities are updated based on actual audit results.

   a. Determined whether post-refund Recovery Act and WHBAA cases are given priority over HERA cases (which must be repaid by law anyway).

   b. Reviewed the IRS's Category-A tolerance levels and determined whether they are adjusted based on examination results for cases triggering specific filter criteria.

C. Reviewed the IRS's processes for examining questionable requests for the Homebuyer Credit filed on amended tax returns (whether worked pre-refund or post-refund).

1. Reviewed closed cases for which the Homebuyer Credit was allowed to determine whether potential areas of noncompliance were adequately addressed.

   a. Selected a statistically valid sample[14] of 384 closed cases for which the Homebuyer Credit was allowed (surveyed before assignment, surveyed after assignment, and closed – no change).

   b. Determined whether the taxpayers provided adequate documentation to substantiate their eligibility for the Homebuyer Credit.

2. Determine whether cases were being worked in appropriate priority order and whether examination results were being used to update priorities.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS's policies, procedures, and practices related to the examination of erroneous claims for the Homebuyer Credit filed on both

[13] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. The sample included 365 claims filed on an amended return from a population of 68,083 records.

[14] The statistical sample size was selected by using a ±5 percent precision, a 50 percent expected error rate, and a 95 percent confidence level. The sample included 242 claims filed on an amended return from a population of 154,640 records.

original and amended returns. We evaluated these controls by assessing the Homebuyer Credit claims selected by the IRS for examination to ensure that only optimal cases were selected and by reviewing statistically valid samples of examined cases to ensure examinations were properly conducted.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Kyle R. Andersen, Director
Bill R. Russell, Audit Manager
Levi J. Dickson, Lead Auditor
Linna K. Hung, Auditor
Michele S. Jahn, Auditor
Nathan J. Smith, Auditor
Arlene Feskanich, Information Technology Specialist

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Divison SE:S
Deputy Commissioner of Operations, Wage and Investment Division SE:W
Deputy Commissioner of Services, Wage and Investment Division SE:W
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Exam Planning and Delivery, Small Business/Self-Employed Division SE:S:E:EPD
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:

Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Program Manager, Policy and Strategic Planning, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CLD:PSP

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $91,746,687 in additional assessments will be made because IRS resources were applied to more productive cases (see page 5).

Methodology Used to Measure the Reported Benefit:

In an information item sent on March 10, 2011, we recommended that the IRS discontinue Homebuyer Credit examinations on pre-refund cases and re-apply its resources to claims identified by one of the fraudulent filters, regardless of whether the claim was based on a CY 2008 purchase or a CY 2009 purchase, and then to the remaining claims based on CY 2009 purchases.

The IRS reported that they would discontinue working the cases immediately. In addition, the IRS agreed to work all claims for the Homebuyer Credit that triggered one of the fraudulent filters and committed to working as many post-refund cases based on CY 2009 purchases as possible.

Based on the recommendations we made, the IRS reported that 16,730 post-refund cases were added to its Examination plan. This included 4,408 claims based on a CY 2008 purchase and 12,322 claims based on a CY 2009 purchase.

CY 2008 Purchases:

We found that the examination disallowance rate[1] for claims based on a CY 2008 purchase processed in cycles 21 thru 23 (PY 2009) was 73.82 percent. By multiplying .7382 by the population of 4,408 fraudulent claims based on a CY 2008 purchase, we estimated that 3,254 claims would be disallowed. We determined that the average credit amount of the fraudulent claims based on 2008 purchases was $6,631.62. By multiplying $6,631.62 by the estimated disallowed population of 3,254 claims, we project that $21,579,291 in Homebuyer Credits will be disallowed.

[1] See Appendix V for a glossary of terms.

CY 2009 Purchases:

We found that the disallowance rate for claims based on a CY 2009 purchase processed in cycles 21 to 23 (PY 2009) was 77.12 percent. By multiplying .7712 by the population of 12,322 claims based on a CY 2009 purchase, we estimated that 9,503 claims would be disallowed. We determined that the average credit amount of the claims based on 2009 purchases was $7,383.71. By multiplying $7,383.71 by the estimated disallowed population of 9,503 claims, we project that $70,167,396 in Homebuyer Credits will be disallowed.

By summing the projected amounts of Homebuyer Credits to be disallowed from each category ($21,579,291 + $70,167,396), we project the total amount of disallowed Homebuyer Credits to be $91,746,687.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $4,708,115 in erroneous Homebuyer Credits processed in cycles 19 and 20 were issued to 627 taxpayers for which the taxpayer had indications of prior home ownership (see page 12).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of taxpayers who claimed Homebuyer Credits on their TY 2008 electronic tax returns and had a ***2(f)***** ************2(f)****************, or had indications of owning a home within three years before the purchase of the home for which the Homebuyer Credit applied.

To determine whether the IRS's manual filters identified these returns during cycles 19 and 20, we matched them to the examination files (Audit Inventory Management System) Closed Case Data File and found that 4,514 claims were not included in the examination files.

We reviewed a statistically valid sample of 355 of the 4,514 claims and found 88 claims (24.7887 percent) with prior home ownership indicators were refunded to taxpayers without any IRS scrutiny. By multiplying 0.247887 by the population of 4,514, we estimate that 1,119 potentially erroneous claims were refunded without any IRS scrutiny.

We determined that the 88 claims in our sample totaled $660,364.25, which divided by the sample size of 355 resulted in an average Credit of $1,860.18 for the sample. By multiplying $1,860.18 by the population of 4,514, we projected that taxpayers received $8,396,853 in potentially erroneous claims without any IRS scrutiny.

The change rate on cases with indications of prior home ownership is 56.07 percent. By multiplying 0.5607 by the 1,119 potentially erroneous claims, we estimate that 627[2] claims would be disallowed if the IRS examines these cases. By multiplying 0.5607 by the $8,396,853 in potentially erroneous claims, we estimate that taxpayers received $4,708,115[3] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $10,132,231 in erroneous Homebuyer Credits processed in cycles 19 and 20 were issued to 1,350 taxpayers for which the taxpayer had a ***2(f)***** ******2(f)****** (see page 12).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of taxpayers who claimed Homebuyer Credits on their TY 2008 electronic tax returns and had a ***2(f)*** *******2(f)********************, or had indications of owning a home within three years before the purchase of the home for which the Homebuyer Credit applied.

To determine whether the IRS's manual filters identified these returns during cycles 19 and 20, we matched them to the examination files (Audit Information Management System) Closed Case Data File and found that 4,514 claims were not included in the examination files.

We reviewed a statistically valid sample of 355 of the 4,514 claims and found 139 claims (39.1549 percent) with ************************2(f)************************** **********************************2(f)********************************** ******************************2(f)********* were refunded to taxpayers without any IRS scrutiny. By multiplying 0.391549 by the population of 4,514, we estimate that 1,767 potentially erroneous claims were refunded without any IRS scrutiny.

We determined that the 139 claims in our sample totaled $1,042,714, which divided by the sample size of 355 resulted in a sample average of $2,937.22. By multiplying $2,937.22 by the population of 4,514, we projected that taxpayers received $13,258,611 in potentially erroneous claims without any IRS scrutiny.

The change rate on cases with a ***************2(f)****** is 76.42 percent. By multiplying 0.7642 by the 1,767 potentially erroneous claims, we estimate that 1,350[4] claims would be disallowed if the IRS examines these cases. By multiplying 0.7642 by the $13,258,611 in

---

[2] Our projection is based on a 95 percent confidence level and a precision (range) of ± 109 (518–736 claims).
[3] Our projection is based on a 95 percent confidence level and a precision (range) of ± $824,182 ($3,883,933–$5,532,297).
[4] Our projection is based on a 95 percent confidence level and a precision (range) of ± 168 (1,182–1,518 claims).

potentially erroneous claims, we estimate that taxpayers received $10,132,231[5] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $5,493,873 in erroneous Homebuyer Credits processed in cycles 19 and 20 were issued to 732 taxpayers for which the taxpayer was a ***2(f)*** (see page 12).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of taxpayers who claimed Homebuyer Credits on their TY 2008 electronic tax returns and had a***2(f)***** *******2(f)********************, or had indications of owning a home within three years before the purchase of the home for which the Homebuyer Credit applied.

To determine whether the IRS's manual filters identified these returns during cycles 19 and 20, we matched them to the examination files (Audit Information Management System) Closed Case Data File and found that 4,514 claims were not included in the examination files.

We reviewed a statistically valid sample of 355 of the 4,514 claims and found 63 claims (17.7464 percent) were refunded to ***2(f)********* taxpayers without any IRS scrutiny. By multiplying 0.177464 by the population of 4,514, we estimate that 801 potentially erroneous claims were refunded without any IRS scrutiny.

We determined that the 63 claims in our sample totaled $472,972, which divided by the sample size of 355 resulted in a sample average of $1,332.32. By multiplying $1,332.32 by the population of 4,514, we projected that taxpayers received $6,014,092 in potentially erroneous claims without any IRS scrutiny.

The change rate on cases with ****2(f)******taxpayers is 91.35 percent. By multiplying 0.9135 by the population of 801 potentially erroneous claims, we estimate that 732[6] claims would be disallowed if the IRS examines these cases. By multiplying 0.9135 by the $6,014,092 in potentially erroneous claims, we estimate that taxpayers received $5,493,873[7] to which they were not entitled.

---

[5] Our projection is based on a 95 percent confidence level and a precision (range) of ± $1,271,170 ($8,861,061-$11,403,401).

[6] Our projection is based on a 95 percent confidence level and a precision (range) of ± 157 (575–889 claims).

[7] Our projection is based on a 95 percent confidence level and a precision (range) of ± $1,187,390 ($4,306,483–$6,681,263).

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $2,873,288 in erroneous refunds were issued to 433 taxpayers under the age of 18 but were not scrutinized by the IRS (see page 13).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 822 taxpayers under the age of 18 who claimed Homebuyer Credits on their TY 2008 electronic tax returns. After notifying the IRS of these 822 cases, the IRS informed us that 345 were audited or already adjusted. The IRS committed to taking corrective actions on the remaining 477 claims.

The change rate on claims made by taxpayers under 18 years of age is 90.87 percent. By multiplying 0.9087 by the population of 477, we estimate that 433 claims would be disallowed if the IRS examines these cases. We determined the average Credit amount of the population of 822 is $6,635.77. By multiplying $6,635.77 by the estimated number of disallowed claims of 433, we project that $2,873,288 in Homebuyer Credits will be disallowed.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 12,808 taxpayers that qualified for the Homebuyer Credit avoided unnecessary IRS examinations and refund delays on their claims (see page 10).

Methodology Used to Measure the Reported Benefit:

Based on our recommendation, the IRS agreed to discontinue working pre-refund cases for the Homebuyer Credit due to the low disallowance rate. We determined that the IRS ultimately discontinued its pre-refund work on March 6, 2011.

To determine the number of taxpayer accounts that would have been needlessly audited with the examination resulting in a full refund of the claim, we obtained a database of returns with claims for the Homebuyer Credit in PY 2011 ********************2(f)********************* ****2(f)*******************. We found that after March 6, 2011, there were 14,960 claims that met the *****2(f)*************** and would have been subject to an examination. Only claims meeting the IRS's *****2(f)******* and the *****2(f)***************, subsequently discussed, were included in this outcome. Claims meeting other filters were evaluated and worked differently by the IRS.

To estimate the number of cases that the IRS would have allowed if it continued working pre-refund cases, we analyzed examination statistics on comparable cases. We determined that the allowance rate for pre-refund cases filed in PY 2010 was 82.51 percent. By multiplying 0.8251 by the population of 14,960 cases, we estimate that 12,343 cases meeting the ***2(f)**** ****2(f)******** criteria would have been examined and allowed.

In addition, we obtained a database of returns with claims for the Homebuyer Credit in PY 2011 made by taxpayers *****2(f)***********. We found that 564 of these cases were filed after March 6, 2011. By multiplying 0.8251 by 564, we estimate that 465 cases meeting the ***2(f)*** ***2(f)******* criteria would have been examined and allowed.

By adding the two populations of 12,343 and 465, we estimate that 12,808 taxpayers would have been burdened with an IRS examination that would have resulted in a refund.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 477 claims for the Homebuyer Credit made by taxpayers under the age of 18 were denied the Homebuyer Credit by the IRS's improper use of post-processing math error authority. Subsequently, the IRS sent a letter of apology (see page 13).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 822 taxpayers under the age of 18 who claimed Homebuyer Credits on their TY 2008 electronic tax returns. After notifying the IRS of these 822 cases, the IRS informed us that 345 were audited or already adjusted. The IRS committed to asserting post-processing math error authority on the remaining 477 claims.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 43 taxpayers were improperly denied $285,338 in Homebuyer Credit claims to which they were entitled (see page 13).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 822 taxpayers under the age of 18 who claimed Homebuyer Credits on their TY 2008 electronic tax returns. After notifying the IRS of these 822 cases, the IRS informed us that 345 were audited or already adjusted. The IRS committed to asserting post-processing math error authority on the remaining 477 claims.

The no change rate on claims made by taxpayers under 18 years of age is 9 percent. By multiplying 0.09 by the number of returns for which the IRS asserted post-processing math error authority of 477, we estimate that the IRS would improperly deny 43 taxpayers claims to which they were entitled. We determined the average Credit amount of the 822 claims is $6,635.77. By multiplying $6,635.77 by the estimated number of allowed claims of 43, we project that $285,338 in Homebuyer Credits will be incorrectly disallowed.

Appendix V

Glossary of Terms

Campus	The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Category-A Criteria	Identifies issues that require a referral to the Examination function classifiers prior to allowing a taxpayer's claim.
Data Center Warehouse	A collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration for the purpose of analyzing data for ongoing audits.
Examination Disallowance Rate	The rate or percentage of claims that are denied or reduced based on an IRS examination.
First-Time Homebuyer	Generally defined as any individual (and spouse, if married) who had no ownership interest in a principal residence during the three-year period prior to the purchase of the home.
Fiscal Year	A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	Contains data transcribed from initial input of the original individual tax returns during return processing.
Math Error Authority	Allows the IRS to systemically disallow certain taxpayer claims at the time a tax return is processed.
Processing Cycle	Processing cycles are the weeks within the calendar year the return or document is processed by the IRS.

Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Refundable Credit	A refundable credit can reduce a taxpayer's liability to zero, and any credit amount over the tax liability can be refunded to the taxpayer. In contrast, a nonrefundable credit can reduce only the tax liability to zero.
Servicewide Electronic Research Program Alert	An internal notice used to immediately notify IRS functions of a change to current procedures.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED JAN 4 2012

January 4, 2012

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively (Audit # 201040151)

Implementation of the First-Time Homebuyer Credit (FTHBC) legislation for Tax Year (TY) 2008, and two subsequent acts affecting TYs 2009 and 2010 presented significant administrative challenges. After the enactment of the FTHBC, greater examination resources were redirected to pre-refund reviews and evaluations of refundable credit claims that were questionable, or appeared to be improper. The scope and magnitude of the credits required coordination across many business units and represented a fundamental shift in our traditional approach to return processing and compliance enforcement.

As noted in the report, the Worker, Homeownership, and Business Assistance Act of 2009 was signed into law on November 6, 2009. In addition to extending the FTHBC, it also provided the IRS with effective tools that significantly enhanced our ability to assess the validity of FTHBC claims during processing and stop those that were found to be ineligible. Primarily, a requirement was placed on taxpayers claiming the credit to provide documentary evidence of the home purchase, such as the closing or settlement statement. The IRS was also given math error authority to deny the credit when documentation was missing or insufficient, or the taxpayer was found to be otherwise ineligible for claiming the credit. This allowed us at the time of processing, to detect and correct more erroneous claims and avoid diverting them for examination review. As with any new process, valuable lessons were learned as we implemented and refined our strategy for detecting and addressing questionable claims.

We have reviewed the outcome measures reported in Appendix IV and we disagree with your finding of Funds Put to Better Use of approximately $92 million. As noted in the report, our examination resources are limited; however, we leverage those resources to the greatest extent possible in fulfilling the objectives of our compliance program. While we changed our case selection methodology, that change did not result only in the audit of an additional 16,730 post-refund FTHBC claims. Rather, it displaced, or caused the non-selection of other claims or returns that would have been examined. The outcome measure does not consider the additional tax assessments, or claim disallowances that would have been derived from those displaced returns.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact James P. Clifford, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.

Attachment

Attachment

RECOMMENDATION 1:
Given limited examination resources, the Director, Compliance, Wage and Investment Division, should use updated examination results to make adjustments throughout the year, which will optimize the overall effectiveness of examinations.

CORRECTIVE ACTION
We agree with this recommendation. We routinely use prior examination results, when available, to develop our selected workloads and to make adjustments throughout the year. We also consider examination results and trends when developing our annual program plans.

IMPLEMENTATION DATE
Implemented and ongoing

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 2:
The Director, Compliance, Wage and Investment Division, should ensure that claims for the Homebuyer Credit processed in processing cycles 19 and 20 are run against the IRS's automated examination filters and that the highest risk cases are selected for post-refund examinations.

CORRECTIVE ACTION
We agree with this recommendation and will examine the highest risk cases.

IMPLEMENTATION DATE
October 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division
Director, Campus Reporting Compliance, Small Business/Self Employed

CORRECTIVE ACTION MONITORING PLAN
The IRS will monitor this corrective action as part of our internal management control system.